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SUBJECT: CHINESE OFFICIALS CONCERNED ABOUT FINANCIAL RISKS

Classified By: Economic Deputy Minister Counselor Robert Forden; Reason  
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11. (C) SUMMARY: People's Bank of China (PBOC) Director General Zhang Tao told us October 16 that the State Administration of Foreign Exchange (SAFE) had been criticized internally by some senior Chinese leaders for its management of foreign exchange holdings, and now needed to mitigate risks to protect itself. He said the senior political leadership also needed to be convinced that the next U.S. administration will stand behind any commitments inherited from the current administration. Zhang confirmed that any reduction in credit availability for foreign banks in the interbank lending market simply reflected risk aversion decisions by individual Chinese banks, and was not driven by government regulators. He believed the Chinese economy was headed for a soft landing, with slower growth and acceptable inflation. Zhang was optimistic that any recession in the U.S. would be relatively short and not too harmful to China. He appeared to agree to the need for further appreciation of the RMB and thought China would continue to pursue this course. Finally, Zhang said last weekend's telephone discussions between U.S. Treasury Secretary Paulson and Vice Premier Wang Qishan regarding the possible participation of President Hu Jintao at a financial crisis summit had resulted in misunderstandings and embarrassment within the Chinese Government. END SUMMARY.

12. (C) In an October 16 meeting, Finatt briefed PBOC Director General for Information and Statistics Zhang Tao on three recent areas of U.S. concern in China related to the ongoing financial crisis: first, that China's State Administration of Foreign Exchange (SAFE) had pulled back from lending U.S. treasuries in the repo market, due to concerns about counterparty risk; second, that SAFE also had been shifting its portfolio from long-term to shorter-term maturities; and third, that U.S. and other foreign banks continue to experience difficulty obtaining credit in the Chinese interbank lending market.

Need to Avoid Risk  
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13. (C) In response, Zhang said SAFE had been criticized internally by some senior Chinese leaders for its management of foreign exchange holdings. As a result, SAFE officials needed to mitigate risks to protect themselves. Zhang said the senior political leadership, whose understanding of financial issues was not deep, need to be convinced that the next U.S. administration will stand behind any commitments inherited from the current administration. If they are not convinced, then they could do nothing to address these U.S. concerns. Zhang offered a similar message on the shift to shorter-term maturities for their holdings of U.S. agency debt, noting that the SAFE portfolio managers and lower level

technocrats are constrained, unless concerns over the long-term status and viability of Freddie Mac and Fannie Mae of their State Council bosses are assuaged.

14. (C) On the interbank lending issue, Zhang confirmed what we have heard consistently from other contacts: any reduction in credit availability in the interbank lending market simply reflected risk aversion decisions by individual Chinese banks, and was not driven by government regulators. Furthermore, he said the PBOC had not taken and would not take a position that this was simply a foreign bank problem. Rather, any foreign bank encountering severe difficulties in its China operations would reflect badly on Chinese financial regulators and senior leaders. He said he knew of one instance where the PBOC had applied moral suasion to at least one large Chinese bank to ensure the availability of financing for a foreign bank.

15. (C) Zhang also said the PBOC was formulating various contingency plans to deal with a bank facing serious liquidity problems, but the first recourse would be to convince Chinese banks to increase their lending, which he believed would be preferable to offering any sort of PBOC lending facility to foreign banks. Zhang said the PBOC would be extremely cautious about making any public announcement in this area, as that could raise concerns among depositors. He also noted that any policy cannot be seen as providing special treatment to foreign banks, even if they are more dependent on interbank financing.

#### China's Soft Landing

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16. (C) Zhang agreed that the Chinese economy appeared headed for a "soft landing," with slower growth and inflation that would not be a problem "for now." He said the PBOC believed it needed to be "flexible" to ensure adequate liquidity in the domestic economy. Zhang also was fairly optimistic that any recession in the U.S. would be relatively short, and that a slowing U.S. economy - even a recession - would not hurt China too much. He observed that even if U.S. households reduced consumption, they would continue to purchase inexpensive consumer staples where China has a comparative advantage during their holiday season.

#### Kick the Habit

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17. (C) Despite slower growth and rising political pressure from exporters, Zhang appeared to agree to the need for further appreciation of the RMB on a trade-weighted basis, together with at least stability but preferably appreciation against the USD, and thought China would continue to pursue this course. He noted, however, that it was difficult for some of China's policy makers to accept a rebalancing of growth from net exports to consumption; in this regard China, he said, was like a tobacco smoker who knew he had to quit but kept postponing the change.

#### Summit Miscommunication

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18. (C) Zhang told us that the previous weekend's (Oct. 11) telephone discussions between U.S. Treasury Secretary Paulson and Vice Premier Wang Qishan regarding the possible participation of President Hu Jintao at a financial crisis summit had resulted in misunderstandings and embarrassment within the Chinese Government. In particular, at some point the preliminary discussion of Hu's availability and interest in attending had been misconstrued as a firm invitation from the U.S., leading some ministries and senior State Council officials to continue to work to prepare for the trip as late as Tuesday night (October 14), 24 hours after MOF and MFA were informed that the summit would not take place on October

18, if at all. The result, according to Zhang, was that "the next time it will be much more difficult" to arrange China's participation in such a meeting.

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